



A New Development in the Thin Capitalization Rules of China



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On September 19, 2008, the Ministry of Finance (“MOF”) and the State Administration of Taxation (“SAT”) of PRC jointly published a Circular on the Relevant Taxation Policies in connection with the Pre-Tax Deduction Standard for the Interest Expenses Paid to the Affiliated Parties of Enterprises (“Circular 121”), which has been promulgated with the view to elaborating the thin capitalization rules newly introduced by the PRC Enterprise Income Tax Law (“EIT Law”) on March 16, 2007 and effective as of January 1, 2008.

The Thin Capitalization Rules have been adopted by many tax jurisdictions to regulate corporations whose capitals are supplied primarily by loans from shareholders rather than stock investment. High percentage loan finance helps these companies obtain more pre-tax deductions of the interest expenses (given the fact that the distributions of dividends are nondeductible). As a result, the prescribed debt/equity ratios normally constitute an important part of the thin capitalization rules, which, however, was not defined in the EIT Law or its Implementing Regulations issued on December 6, 2007.

Circular 121 provides two debt/equity ratios: i.e. 5:1 for financial institutions and 2:1 for others. The interest expenses paid to the affiliated company exceeding the above thresholds will not be deductible except the company can provide supporting documentation evidencing that the intra-group financing was at arm’s length, or if the effective tax rate of the borrowing enterprise is not higher than the rate of the domestic related party receiving the interest (Article 2).



Other key provisions of Circular 121 include:

- An enterprise carrying out both financial and non-financial business must separate the interest expenses in connection with the different types of the services on a reasonable basis; otherwise, the debt/equity ratio of 2:1 will be applicable to the entire interest expenses of the enterprise.
- The enterprises receiving the disqualified interest from any affiliated companies will be subject to the enterprise income tax in accordance with the EIT Law.

Although Circular 121 has provided an essential road map for the Thin Capitalization Rules of China, there still exist certain issues unresolved under this 4-article document. Examples include the definitions of “domestic company” and “financial institution”, calculation methods for the debt/equity ratios, detailed documentation requirements for the deductible excessive interest expenses, etc. Hopefully, these issues can be further clarified in other SAT implementing rules (including a rule on special tax adjustment) expected to be issued in the near future.

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